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No. 90-293

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1990

WHEREHOUSE ENTERTAINMENT, INC., *et al.*,
Petitioners,

—v.—

McMAHAN & COMPANY, *et al.*,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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Questions Presented

1. Whether the Court of Appeals correctly held that a bond prospectus, which emphasized a special "optional tender" for the bondholders in the event of a leveraged transaction or takeover, could be found by a reasonable trier of fact to violate § 11 of the Securities Act of 1933 and § 10(b) of the Securities Exchange Act of 1934 when the issuer expected never to permit investors to exercise their purported "option to require" redemption of the bonds?

2. Whether the Court of Appeals correctly held that an oral representation that the "optional tender" provision was a "protective covenant for the debentureholders" could be found by a reasonable trier of fact to violate § 12(2) of the Securities Act of 1933 when the provision was intended as a bargaining chip for the protection only of management and shareholders?

Statement Pursuant to Rule 28.1

Respondent Froley, Revy Investment Co. Inc. is wholly owned by Southwest Asset Management and is an affiliate of Froley, Revy Asset Traders.

Respondent Wechsler & Krumholz, Inc. does not have any parent, subsidiary (other than a wholly owned subsidiary) or affiliate.

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RESPONDENTS' BRIEF IN OPPOSITION

Respondents McMahan & Company, Froley, Revy Investment Co., Inc. and Wechsler & Krumholz, Inc. (collectively, "McMahan") respectively request that the Court deny the petition for a writ of certiorari seeking review of the Second Circuit's opinion in this case. That opinion is reported at 900 F.2d 576 (2d Cir. 1990).

Statement of the Case

A. Nature of the Case

Petitioner Wherehouse Entertainment, Inc. ("Wherehouse" or the "Company") issued 6¼ percent convertible subordinated debentures under a registration statement and prospectus dated July 10, 1986. The prospectus' cover page highlighted a special covenant called the

"Optional Tender" provision, a provision which was described in the bond indenture itself as the "Holder's Right to Tender." (57a; 64a).[1]

This special feature of the new security purported to give investors the right to "require the Company to redeem the debentures" at the "option" of the investor if: (i) a person or group attained ownership of 80 percent of Wherehouse stock entitled to vote, (ii) Wherehouse was merged into another company, or (iii) Wherehouse incurred debt in excess of 65 percent of its capitalization, "unless" approved by a majority of Wherehouse's "Independent Directors." (57a-58a).

At sales meetings, Wherehouse and its underwriter, petitioner Furman Selz Mager Dietz & Birney, Inc. ("Furman Selz") promoted this feature to potential investors as a "protective covenant" and a "special protection for debentureholders." (29a). Debenture purchasers such as McMahan believed—based on the prospectus and on what Wherehouse said—that the "purpose of the right to tender was to protect debentureholders and that [their] investment would be returned to [them] in the event the harmful effects of a merger or excess debt occurred." (39a).

The debentureholders' purported right "to require" redemption could never as a practical matter be exercisable, even in a hostile takeover. But Wherehouse never publicly disclosed that fact when the debentures were marketed and sold. Nor did Wherehouse disclose that the "holder's right to tender" was merely a legal artifice engineered to give its management a bargaining chip in the event of an unwanted takeover bid. To the contrary, by stressing the "optional tender" in the summary of important provisions on the prospectus' cover page, and by using the language of entitlement (the bondholders had the *"option"* to *"require"* redemption), Wherehouse em-

[1] References to the appendix reproduced with Wherehouse's Petition for a Writ of Certiorari are cited "(— a)."

phasized the "optional tender" as one of the debentures' most important features. (57a).

Less than 18 months after it issued the debentures, Wherehouse agreed to a leveraged buy-out and merger that met all three of the criteria triggering the "right to tender." McMahan sought to exercise its right to require redemption. Wherehouse rejected McMahan's claim, asserting that the Wherehouse "board of directors" had approved the merger." (4a). The "Independent Directors" referred to in the prospectus had apparently never even met as a group, either to discuss the leveraged buy-out and merger or to consider the interests of the debentureholders. Wherehouse claimed (though it had not earlier disclosed) that the bond indenture gave it unrestricted discretion to enter into the harmful transactions against which the "holder's right to tender" purported to protect the bondholders. (40a).

The injuries that the "right to tender" pretended to guard against fell fully upon the debentureholders. McMahan and other investors were left holding debentures valued at only 50 percent of par. (4a). The merger had eliminated the key economic feature of the investment, the right to convert the 6¼ percent debentures into Wherehouse stock, and left the bondholders with a fixed conversion right valued at only $50. The merger had also left Wherehouse with debt approaching 90 percent of its capitalization. (4a).

This action was commenced on January 22, 1988, seeking, among other relief, to require Wherehouse to redeem the debentures. Before any substantial discovery could occur, the defendants moved to dismiss the complaint. The District Court (Lowe, J.) referred the motion to a Magistrate (Roberts, Mag.), who by order dated March 24, 1988, stayed all discovery. By Report dated August 10, 1988, the Magistrate recommended that summary judgment be granted dismissing the complaint. (53a).

Without having held a conference or a hearing in the case, the District Court "adopt[ed] the reasoning" of the Magistrate and granted summary judgment dismissing the complaint on May 22, 1989. (20). McMahan appealed that ruling to the Second Circuit, which reversed the District Court and remanded the case for further proceedings in an opinion dated April 10, 1990. (3a). On June 7, 1990 the Second Circuit denied Wherehouse's motion for a stay of its mandate pending review by this Court. The case is now proceeding in the district court.

B. The Decision Below

The decision of the Court of Appeals held that McMahan had "presented sufficient evidence to create a genuine issue" of fact as to whether Wherehouse's offering materials were "materially misleading" in violation of Sections 11 and 12(2), of the Securities Act of 1933, 15 U.S.C. §§ 77k and 77*l*(2), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). (3a; 900 F.2d at 577). It remanded the case for further proceedings—*i.e.*, discovery, which had been almost entirely thwarted in the district court, and trial. *Id.*

This fact-based decision made no new law. The Court of Appeals carefully reviewed the text of the challenged prospectus and the words of the challenged oral statements. The crux of the decision below was that a jury could find that, "when read as a whole, the defendants' representations connoted a richer message than that conveyed by a literal reading of the statements." (6a; 900 F.2d at 579). As Judge Pratt elaborated:

> [t]he central issue on all three claims is not whether the particular statements, taken separately, were literally true, but whether defendants' representations, taken together and in context, would have misled reasonable investor about the nature of the debentures.

Id.

The Court of Appeals' decision analyzed each of McMahan's claims as follows:

1. Section 11 of the Securities Act of 1933

The Court of Appeals based its decision upon the specific language of the prospectus before it. The court observed that the prospectus's summary of key debenture features included a special "optional tender" provision, described in the prospectus as follows:

> Each holder of the Debentures has the *option to require* the Company to redeem the holder's Debentures.

(8a; 900 F.2d at 579) (emphasis in opinion). The court also noted that the body of the prospectus stated:

> Holders of the Debentures *will have the option* * * * *to require* the Company to redeem such Debentures.

(8a; 900 F.2d at 580) (emphasis in opinion). From these and related representations the Court of Appeals concluded that "the offering materials can reasonably be read to present the option to tender as a valuable right." (8a; 900 F.2d at 579).

Next, the court below considered the section of the prospectus describing the "Effect on Certain Takeovers" of the right to tender, which stated that

> Since the events which give rise to such right of redemption could be expected to occur in connection with certain forms of takeover attempts, the optional tender provisions could deter takeovers where the person attempting the takeover views itself as unable to finance the redemption of the principal amount of Debentures which may be tendered * * * To the extent that Debentures may be tendered * * * the Company would be unable

> to use the financing provided by the sale of the Debentures offered hereby. In addition, the ability of the Company to obtain additional Senior Debt based on the existence of the Debentures would be similarly adversely affected.

(8a-9a; 900 F.2d at 580) (ellipses in opinion). From this provision, the Court of Appeals concluded that "a jury could reasonably view the presentation of the right to tender as a special feature to protect investors, for the offering materials stressed the purported value of the right in any takeover transaction which would threaten the value of the debentures." (8a; 900 F.2d at 580).

Next, the Court of Appeals considered the role of the "Independent Directors" in restricting the right to require redemption by again looking at the specific language of the prospectus. Observing that the prospectus repeatedly stated that the right to require redemption arose upon certain triggering events " '*unless* [the event is] approved by a majority of the Independent Directors,' " the court concluded that "[a] jury could reasonably find that this repeated use of the word 'unless' encouraged the inference that exercise of the right would be the norm and that waiver would be the exception." (9a; 900 F.2d at 580).

The court also found that "[a]lthough the offering materials explain that the Independent Directors would be chosen from the company's board of directors, the term "Independent Director" implies a special status, some distinction from an 'ordinary' director." *Id.* Indeed, the prospectus nowhere describes the standards governing the Independent Directors' power of "approval." The court thus concluded that the prospectus "could reasonably be understood to mean that in the case of a triggering event, the right to tender would arise *unless* the Independent Directors find the event to be in the interests of the debentureholders." (10a; 900 F.2d at 580).

Finally, the court observed that the "Independent Directors":

> had a fiduciary duty to protect the interests of shareholders in any takeover situation, regardless of debentureholders' interests or rights. It is inevitable, then, that the so-called Independent Directors had no independence; they would never protect the interests of debentureholders. . . .

Id. As a result, the Court of Appeals concluded that there may be "merit in plaintiffs' contentions that the right to tender was illusory." *Id.*

The court consequently held that McMahan "raised a genuine issue as to whether the written representations could have misled a reasonable investor, and summary judgment was therefore unwarranted." (11a; 900 F.2d at 581) (citation omitted).

2. Section 12(2) of the Securities Act of 1933

The court below also addressed the oral representations made by Wherehouse and its underwriter, Furman Selz, in which the right to tender was described as a "protective covenant" and "special protection" for debentureholders. The court found this language "could be found to have implied that debentureholders would be protected against takeovers hostile to their own interests, regardless of the interests of shareholders, and thus to have misled plaintiffs as to the true nature of the right." (12a; 900 F.2d at 581). The court consequently found that an issue of fact precluded summary judgment on the § 12(2) claim.

3. Section 10(b) of the Securities Exchange Act of 1934

The Court of Appeals below found that the same issues of fact which precluded summary judgment on

McMahan's claims under the Securities Act of 1933 precluded summary judgment on its Section 10(b) claim. "Since we have concluded that a question of fact is presented as to whether the offering materials and oral communications, taken together, could have misled a reasonable investor, it follows that a jury should also determine whether the defendants violated § 10(b)." (13a; 900 F.2d at 582).

Reasons The Petition Should Be Denied

Wherehouse has not shown why the Court should interfere with the Court of Appeals' order remanding this case for discovery and trial on the merits.[2] Wherehouse cites no authority in conflict with the decision below, which held only that a reasonable jury could, after trial on the merits, find the challenged Wherehouse prospectus and oral representations to be misleading. Indeed, as we show below, Wherehouse manufactures purported "conflicts" only by misreading and distorting the decision below. Nor does the Court of Appeals' fact-specific decision raise any important question of federal law.

I.

The Petition Cites No Conflict Between Circuits.

The decision below stands only for the proposition that the emphasis upon and manner of presentation of the

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[2] Remand orders by the Courts of Appeals are generally not appropriate vehicles for exercise of this Court's discretionary *certiorari* jurisdiction. *See Brotherhood of Locomotive Firemen and Enginemen* v. *Bangor & Arrostook Railroad Co.*, 389 U.S. 327 (1967) ("because the Court of Appeals remanded the case, it is not yet ripe for review by this Court"). *See also Hamilton Brown Shoe Co.* v. *Wolf Bros. & Co.*, 240 U.S. 251, 258 (1916) ("except in extraordinary cases, the writ is not issued until final decree").

"optional tender" in the Wherehouse prospectus and in oral statements could mislead investors. This unremarkable principle is amply supported in the case law. See, for example, *Isquith* v. *Middle South Utilities Inc.*, 847 F.2d 186, 201 n.9 (5th Cir.), *cert. denied*, 109 S. Ct. 310 (1988), in which the Fifth Circuit observed that:

> information is imparted not just through the use of individual words—information is also gained from the context in which those words are placed. When determining what has been disclosed, therefore, it is wrong to treat each individual piece of information separately, as if it had no relation to the other pieces which surround it.

See also *Greenapple* v. *Detroit Edison Co.*, 618 F.2d 198, 205 (2d Cir. 1980), in which the Second Circuit stated that "notwithstanding the board discretion which issuers have in assembling and organizing their data, where the method of presentation obscures or distorts the significance of material facts, a violation of Section 11 will be found."

No decision conflicts with the application of this general principle to the prospectus and oral representations at issue in this case. To the contrary, the most closely analogous case, *Harris* v. *Union Electric Co.*, 787 F.2d 355 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986), accords with the decision below. In *Harris*, the Eighth Circuit found misleading a public utility bond prospectus that made no untrue statements, but failed adequately to describe a legal loophole.

Wherehouse concocts supposed conflicts by misreading the decision that the Court of Appeals in fact wrote. Nowhere does the Court of Appeals even imply that a "pejorative characterization of disclosed facts" is required. (Wherehouse Petition for a Writ of Certiorari ["Petition"] at 11). Wherehouse failed to disclose all material facts about its "right to tender." Instead, it presented as

an important right a supposed "option" to "require" redemption that was neither an option nor a requirement. For this reason, all of the purportedly "conflicting" decisions of the Courts of Appeals cited by Wherehouse at pages 11 to 13 of its petition are readily distinguishable.[3]

The Court of Appeals did not assume, as Wherehouse insists, that there is a "duty to disclose legal conclusions or to provide advice concerning the legal consequences

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[3] None of the cases cited addresses the proper disclosure of a legal construct such as the "right to tender" here. Most of the cases address the proper disclosure of individuals' interests in proposed transactions, and conclude that once the facts underlying a potential conflict or improper motive are disclosed, then the interest need not be labelled as such. *See Lessler* v. *Little,* 857 F.2d 866 (1st Cir. 1988), *cert. denied,* 109 S.Ct. 1130 (1989) (defendants' "special fee" for proposed transaction); *Kas* v. *Financial General Bankshares, Inc.,* 796 F.2d 508 (D.C. Cir. 1986) (attorneys' representation of both parties to transaction); *Data Probe Acquisition Corp.* v. *Datatab,* 722 F.2d 1 (2d Cir. 1983), *cert. denied,* 465 U.S. 1052 (1984) (post-merger guarantee of employment to directors); *Alabama Farm Bureau Mutual Casualty Co.* v. *American Fidelity Life Insurance Co.,* 606 F.2d 602 (5th Cir. 1979), *cert. denied,* 449 U.S. 820 (1980) (size and scope of stock repurchase plan); *Golub* v. *PPD Corp.,* 576 F.2d 759 (8th Cir. 1978) ("bonus" to controlling shareholders in sale of shares); *Goldberg* v. *Meridor,* 567 F.2d 209 (2d Cir. 1977), *cert. denied,* 434 U.S. 1069 (1978) (stating in dicta that conflict of interest transactions need not be characterized with pejorative adjectives, but that nondisclosure of facts would be seriously misleading).

The remaining cases cited by Wherehouse do not even support its point. *Bulgo* v. *Munoz,* 853 F.2d 710 (9th Cir. 1988) and *Presidio Enterprises, Inc.* v. *Warner Bros. Distributing Corp.,* 784 F.2d 674 (5th Cir. 1986) cannot establish any conflict because they are not cases arising under the federal securities laws, but under Hawaii's State Securities Act and Texas' Deceptive Trade Practices Act, respectively. *Biesenbach* v. *Guenther,* 588 F.2d 400 (3d Cir. 1978) did not hold that a statement that a transaction was in the "best interests of the shareholders" could not be misleading. Rather, the court held that the real issue—whether or not the transaction was in the shareholders' best interests—was an issue of state law, not federal securities law, in accordance with *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462 (1977).

flowing from disclosed facts." (Petition at 14). Again, this argument distorts the Court of Appeals' careful and fact-specific inquiry.

The Court of Appeals observed that the prospectus implied "that Independent Directors were to render independent votes on the right to tender based on the impact of a merger and on the interests of debentureholders." (11a; 900 F.2d at 581). Wherehouse thus implied the opposite of the law as it understood it; it suggested that "Independent Directors" would be guided by the interests of debentureholders when, as Wherehouse now acknowledges, the "Independent Directors" owed conflicting obligations to shareholders.

Based upon these premises—that the "optional tender" was presented as a substantial right and that the Independent Directors would consider the debentureholders' interests in approving a transaction—the Court of Appeals concluded that Wherehouse could be required to make disclosures to correct its misleading presentation; for example, a disclosure that the Independent Directors "would inevitably waive the right in any merger beneficial to management regardless of debentureholders' interests. . . ." *Id.* The cases cited by Wherehouse in its petition are easily distinguished because, unlike here, in none of these cases did the defendant present a misleading emphasis on a supposed right or suggested that the law was other than what it was.[4] On this point too, Wherehouse posits a false conflict.

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[4] In neither case cited by Wherehouse did the defendant mislead the plaintiff by clothing an illusory right in the language of entitlement. In *Vohs* v. *Dickson,* 495 F.2d 607 (5th Cir. 1974), plaintiff purchasers were as aware as the defendant that they were buying unregistered stock; the defendant had not made any misrepresentation which could have led them to a mistaken belief about the stock's transferability. In *Ash* v. *LFE Corp.,* 525 F.2d 215, 220 (3d Cir. 1975), the court held that a proxy solicitation did not have to disclose a "speculative" legal theory, which under any analysis could not have been material.

Finally, Wherehouse submits that "when the Debentures were issued it was simply not possible for anyone to know whether the optional right to tender would ever be triggered" and therefore the decision below conflicts with decisions holding that "parties are not required to disclose speculative predictions as to what may happen in the future." (Petition at 16). Again, Wherehouse argues from a faulty premise. No speculation is involved because, by Wherehouse's own admission, the right to tender would never be triggered for the debentureholders' benefit. Moreover, the existence of the "right to tender" is not contingent, it is a contract right set forth in the indenture that Wherehouse wrote at virtually the same time it wrote the prospectus. Wherehouse is not insulated from providing proper disclosure of this contract term because, like many contract terms, it is conditional, or because the contract was written to be as misleading as the prospectus. Not one of the Court of Appeals cases cited gy Wherehouse at page 16 of its petition deals with the proper disclosure of purported rights such as the "right to tender" here.[5] They do not conflict with the decision below.

II.

The Petition Does Not Raise An Important Issue Of Law.

The foregoing discussion establishes that the decision below is not about an issue of law but of fact: whether Wherehouse's prospectus and oral statements were mate-

[5] The cases Wherehouse points to as evidence of a conflict—*Flynn* v. *Bass Bros. Enterprises, Inc.*, 744 F.2d 978 (3d Cir. 1984), *Panter* v. *Marshall Field & Co.*, 646 F.2d 271 (7th Cir.) *cert. denied*, 454 U.S. 1092 (1981) and *Rodman* v. *Grant Foundation*, 608 F.2d 64 (2d Cir. 1979)—deal with disclosure of financial projections or predictions. Such soft financial information can indeed be termed speculative, unlike the option to tender which would never be exercisable.

rially misleading. Wherehouse asserts that this case is important because covenants similar to the "right to tender" at issue here "are common provisions found in hundreds of Indentures issued in recent years. . . ." (Petition at 9). The decision below does not even address the validity of such covenants; its only concern is their proper disclosure. The decision below will have no impact whatsoever on the "hundreds" of companies that issued bonds with a similar covenant—unless they, like Wherehouse, touted the covenant as a "protective covenant for debentureholders" and camouflaged its illusory value in public disclosures.

Finally, Wherehouse manufactures similarities between this case and *Virginia Bankshares* v. *Sandberg*, 110 S.Ct. 1921 (1990), in which this Court recently granted a petition for *certiorari*.[6] Wherehouse relies upon the happenstance that the word "independent" appears in both sets of challenged public materials. Whether Virginia Bankshares misleadingly used the word "independent" to describe an investment banker can have no bearing on

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[6] In *Virginia Bankshares*, a proxy statement distributed to minority shareholders in connection with a going-private merger was found after jury trial to contain material misrepresentations and omissions. The controlling shareholder had hired an advisor, styled in the proxy statement as an "independent" investment banker, " 'to pass on the fairness of the merger from a financial point of view.' " *Sandberg* v. *Virginia Bankshares, Inc.*, 891 F.2d 1112, 1122 (4th Cir. 1989), *cert. granted*, 110 S.Ct. 1921 (1990). The Fourth Circuit held that the proxy's representation that the fairness opinion was "an independent determination could certainly have been found to be a material misrepresentation"—even though it was disclosed that the banker had been hired by the controlling shareholder, that it based its opinion on information provided by the controlling shareholder, and that it did not attempt to verify independently such information. *Id.* The debentureholders here, by contrast, were never told that the highlighted "optional tender" would never be exercised, or that the "Independent Directors" would consider only shareholder interests, not their own.

whether Wherehouse presented a "holder's right to tender" that was meaningless and perpetrated this deception in part by using the word "independent." *Virginia Bankshares* has no connection to this case.

Conclusion

For the reasons stated above, respondents request that the petition for a writ of *certiorari* be denied.

September 13, 1990

Respectfully submitted,

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